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STATE FOR EAP/CM AND EEB/IFD/OMA;
TREASURY FOR MCCORMICK, DOHNER, HOLMER, OASIA

E.O. 12958: DECL: 01/18/2018
TAGS: ECON EFIN HK CH
SUBJECT: HKMA SAYS CHINESE REGULATORS MOVING BACKWARDS ON LIBERALIZATION

Classified By: EP Chief Laurent Charbonnet, Reasons 1.4 b/d

¶1. (C) Summary: Hong Kong Monetary Authority (HKMA) officials share U.S. concerns about tighter restrictions emanating from the Chinese Securities Regulatory Commission (CSRC) and said CSRC officials score political points for resisting U.S. demands. HKMA is lobbying the Chinese Banking Regulatory Commission (CBRC) to relax its three-year operations requirement before an incorporated foreign bank can issue RMB-denominated subordinated debt to increase its capital. Chinese requirements that foreign banks move their debit and credit card data processing operations to Mainland China are driven by fear of losing access to individuals, financial data. Hong Kong-based analysts agree that Chinese officials should tolerate a higher long-term rate of inflation given China's continued high growth. While the Chinese Central Bank's inflation target of 3% is too low and the risks of a disinflationary drop in external demand is rising, the balance of risks call for further monetary tightening, preferably through a stronger exchange rate. Former Beijing Mayor Wang Jishan is expected by almost all analysts to take over the financial portfolio as Vice Premier. While Wang is expected to oversee the financial regulatory agencies, and will be a more decisive leader able to resolve interagency disputes impeding reforms, analysts question whether financial regulators will be consolidated into a unified agency. End Summary.

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HKMA Concerned Financial Liberalization is Slipping
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¶2. (C) U.S. Embassy Beijing Minister Counselor for Financial Affairs David Loevinger, Deputy Financial Attach Hugo Yon and ConGen Hong Kong Econoff met with Hong Kong-based analysts and senior HKMA officials to discuss recent developments in financial services and in the Chinese economy. HKMA Deputy Chief Executive Peter Pang and Executive Director Julia Leung (protect) echoed U.S. concerns that the CSRC is tightening restrictions on foreign financial services companies, credit rating agencies in particular. The CSRC is trying to protect Chinese securities companies. CSRC officials have boasted to HKMA officials about resisting U.S. demands and a change in leadership, and particularly at the CSRC, is probably the only way to reverse this position, said Pang.

¶3. (C) HKMA also shared U.S. concerns about continued obstacles to foreign banks, ability to issue their own credit and debit cards (foreign banks can now only do so through joint ventures with Chinese banks). While the China Banking Regulatory Commission has granted incorporated foreign banks licenses to issue cards, the People's Bank of

China continues to require these banks to move their data processing to Mainland China. HKMA officials lamented that, for purposes of data processing, Hong Kong is not considered part of China (M-C Loevinger noted that his mid-January conversations with officials in PBOC's payments bureau confirm that this remains the PBOC's position). Leung attributed this reluctance to "privacy" concerns; both the concern that other governments would get access to information about Chinese consumers and fears that Chinese authorities would lose access to financial data. She added that Chinese officials note that after the U.S. government began to access SWIFT data, the European Commission required European banks to safeguard personal data of European citizens by moving their data operations to Europe. Even more worrying to HKMA was a report that the CBRC would require all foreign banks incorporated in China to process data domestically (not just credit and debt card transactions). While Loevinger noted that one large foreign bank would ultimately agree to move its data processing operations Leung suggested that the U.S. and HK governments and foreign banks maintain a unified position for now to at least allow foreign banks to maintain data operations in Hong Kong (close hold).

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HKMA asks Chinese Govt. to Relax RMB Debt Requirements
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¶4. (C) HKMA officials welcomed the SED agreement to allow foreign banks to issue RMB-denominated debt. They are asking the central government to relax prudential regulations on the ability of foreign banks incorporated in China to issue RMB-denominated subordinated debt to meet their capital requirements. Current regulations require three years of

Chinese operations before subsidiaries of international banks are allowed issue this debt to grow their business. HKMA is advocating that time spent as Chinese branches of international banks, rather than just time as subsidiaries, should count towards that three year requirement. Leung added that it is always easier to ask the central government to reinterpret the rules than to ask for change. (Beijing FINATT Comment: Given increased difficulty in gaining approval from the State Administration of Foreign Exchange to bring in foreign exchange to expand banks, capital, the ability to issue RMB-denominated subordinated debt is increasingly important to foreign banks. End comment).

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HK-Based Analysts See Chinese Inflation Risks
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¶5. (U) Discussing the risks of inflation on the Mainland and necessary monetary policy responses, Hong Kong-based analysts from JP Morgan and Citi both expected inflation rates to fall as the impact of temporary agricultural supply shocks wanes, but to remain moderately high due to continued buoyant monetary conditions. Asianomics, Jim Walker believes current investment already in the pipeline will continue to drive rapid economic growth and encourage accelerating inflation. All agreed that the Chinese government has historically been excessively adverse to moderate rates of inflation, given that most emerging economies with sustained high rates of growth have also had moderate levels of inflation (Comment: particularly those with rigid exchange rates. End comment).

¶6. (U) Analysts all felt that the People's Bank of China current inflation target of 3% is too low. Citibank's Huang Yiping noted however that the official inflation figures underestimate the true level by at least 1.5 percentage points and agreed that the recent adjustment by the World Bank in the size of China's economy at purchasing power exchange rates was an indication that inflation has been underestimated for an extended period. Huang noted that

administrative controls were keeping prices down and the CPI basket under-represents key components of the economy, with higher than average inflation rates, including housing, health care, and services. JP Morgan's Frank Gong agreed, but estimated that 6% inflation would be tolerable. The current rate of 6.9% worries Chinese policymakers, he said, and was the inspiration for additional price controls on fuel. (Note: The Chinese Government subsequently announced price controls on several agricultural products). However, tightening rhetoric has yet to be supported by significant policy measures to restrain the credit or investment growth. Chinese inflationary expectations are on the rise and will spur continued inflationary pressure as well as hoarding of price-controlled goods.

¶7. (U) Continued RMB appreciation is the right response to accelerating inflation, said Gong. The debate in Chinese policy circles is no longer about whether to allow the RMB to strengthen, it is about whether it is better to allow a one-off adjustment or to continue to allow gradual appreciation. Over the past two months, the RMB has appreciated by 1% per month against the U.S. dollar (a 17% annualized rate); it is clearly a coordinated policy shift since the National Party Congress in October. Huang noted that a discreet one-off appreciation that falls short of what market participants believe is needed to achieve expectations of two-way risk (Huang's clients tell him this would need to be an increase of 15-20%) would only encourage additional capital inflows and that an increase in the rate of appreciation is more likely to foster an orderly adjustment. All were disappointed by the government's increased use of price controls as it would add to distortions in the economy and dampen price signals necessary to encourage agricultural production and reduce investment in energy-intensive sectors.

¶8. (U) Analysts thought that the PBOC's shift in 2007 away from sterilization bonds and toward reserve requirements as a way to soak up liquidity was driven by the PBOC's declining net income as interest rate spreads have narrowed (and in some maturities inverted) between U.S. dollar and RMB-denominated bonds. Most felt that scope for further increases in reserve requirements is increasingly limited (with perhaps room for a cumulative increase of 100-200 basis points) given the adverse impact on commercial banks, net income.

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China's Biggest Worry? U.S. Slowdown
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¶9. (U) Analysts agree that China's biggest worry now isn't inflation, but slowing external demand, particularly from a rapidly slowing U.S. economy. If the global economy does slow, the central government's strong fiscal position will allow it to loosen fiscal policy to boost domestic demand. It's hard to imagine Chinese domestic demand slowing in the near term, said Huang. JP Morgan is predicting slightly slower Chinese growth in 2008 said Gong, but he expects the central government to resort to fiscal stimulus if the growth rate falls below 9%. Both Huang and Gong thought that public infrastructure to reduce bottlenecks would continue to be productive investments and the best fiscal response, if needed.

¶10. (C) Wang Jishan is widely expected to be appointed as Vice Premier in charge of financial policy in the next government. Analysts and officials were optimistic Wang's experience in the financial sector (as CEO of China Construction Bank) and his decisive style would allow him to effectively coordinate the sometimes inconsistent policies of the financial regulatory agencies. Gong predicted that a government reorganization would place Wang in charge of all of the financial regulatory bodies. HKMA officials hope Wang's appointment means there will finally be one hand on

the financial policy tiller and that his presence would lead to speedier financial liberalization.

¶11. (C) Beijing Minister-Counselor for Financial Affairs Comment: CSRC's comments to HKMA that they gain politically by resisting U.S. demands highlights the occasional dilemma of engaging China bilaterally through high-level foray that seek agreement to specific USG requested "deliverables." Both foreign financial services contacts and Chinese government officials have stressed that in some circumstances high level U.S. advocacy of policy changes can delay their implementation. Discussions with HK-based analysts highlight how the weakening of the U.S. economy and shift in U.S. monetary policy have made the Chinese monetary policy decisions more difficult. Coincident indicators of inflation and investment remain high. Household and business surveys point to rising inflationary expectations. And most importantly, there has been an historical tendency to boost investment when new central and local government officials take office, as they will this March. All of these factors strengthen the case for monetary tightening. However, mainland monetary officials are likely to be cautious about tightening, given the uncertainty about external demand, particularly in the U.S., and the risks of an extended downturn. Moreover, the decline in U.S. interest rates has increased the cost to the PBOC of sterilized intervention, leading the PBOC to pass on the cost increasingly to commercial banks through greater use of reserve requirements paying lower interest rates. To limit the adverse impact on banks, income, monetary officials have had to maintain high intermediation spreads through ceilings and floors on deposit and loans rates, respectively. And just as reserve requirements and lending quotas hurt the most efficient banks, floors on lending rates hurt the most efficient and credit worthy borrowers.

¶12. (U) Beijing Financial Minister-Counselor for Financial Affairs David Loevinger cleared this message.

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